data (as appropriate), and audited financial reports (as defined in § 438.3(m)) that demonstrate experience for the populations to be served by the MCO, PIHP, or PAHP to the actuary developing the capitation rates for at least the three most recent and complete years prior to the rating period.

(2) States and their actuaries must use the most appropriate data, with the basis of the data being no older than from the 3 most recent and complete years prior to the rating period, for setting capitation rates. Such base data must be derived from the Medicaid population, or, if data on the Medicaid population is not available, derived from a similar population and adjusted to make the utilization and price data comparable to data from the Medicaid population. Data must be in accordance with actuarial standards for data quality and an explanation of why that specific data is used must be provided in the rate certification.

(3) *Exception.* (i) States that are unable to base their rates on data meeting the qualifications in paragraph (c)(2) of this section that the basis of the data be no older than from the 3 most recent and complete years prior to the rating period may request approval for an exception; the request must describe why an exception is necessary and describe the actions the state intends to take to come into compliance with those requirements.

(ii) States that request an exception from the base data standards established in this section must set forth a corrective action plan to come into compliance with the base data standards no later than 2 years from the rating period for which the deficiency was identified.

(d) *Trend.* Each trend must be reasonable and developed in accordance with generally accepted actuarial principles and practices. Trend must be developed primarily from actual experience of the Medicaid population or from a similar population.

(e) *Non-benefit component of the rate.* The development of the non-benefit component of the rate must include reasonable, appropriate, and attainable expenses related to MCO, PIHP, or PAHP administration, taxes, licensing and regulatory fees, contribution to reserves, risk margin, cost of capital, and other operational costs associated with the provision of services identified in § 438.3(c)(1)(ii) to the populations covered under the contract.

(f) *Adjustments.* Each adjustment must reasonably support the development of an accurate base data set for purposes of rate setting, address appropriate programmatic changes, reflect the health status of the enrolled population, or reflect non-benefit costs, and be developed in accordance with generally accepted actuarial principles and practices.

(g) *Risk adjustment.* Prospective or retrospective risk adjustment methodologies must be developed in a budget neutral manner consistent with generally accepted actuarial principles and practices.

§ 438.6 Special contract provisions related to payment.

(a) *Definitions.* As used in this part, the following terms have the indicated meanings:

Base amount is the starting amount, calculated according to paragraph (d)(2) of this section, available for pass-through payments to hospitals in a given contract year subject to the schedule in paragraph (d)(3) of this section.

Incentive arrangement means any payment mechanism under which a MCO, PIHP, or PAHP may receive additional funds over and above the capitation rates it was paid for meeting targets specified in the contract.

Pass-through payment is any amount required by the State to be added to the contracted payment rates, and considered in calculating the actuarially sound capitation rate, between the MCO, PIHP, or PAHP and hospitals, physicians, or nursing facilities that is not for the following purposes: A specific service or benefit provided to a specific enrollee covered under the contract; a provider payment methodology permitted under paragraphs (c)(1)(i) through (iii) of this section for services and enrollees covered under the contract; a subcapitated payment arrangement for a specific set of services and enrollees covered under the contract; GME payments; or FQHC or RHC wrap around payments.

Risk corridor means a risk sharing mechanism in which States and MCOs, PIHPs, or PAHPs may share in profits and losses under the contract outside of a predetermined threshold amount.

Withhold arrangement means any payment mechanism under which a portion of a capitation rate is withheld from an MCO, PIHP, or PAHP and a portion of or all of the withheld amount will be paid to the MCO, PIHP, or PAHP for meeting targets specified in the contract. The targets for a withhold arrangement are distinct from general operational requirements under the contract. Arrangements that withhold a portion of a capitation rate for noncompliance with general operational requirements are a penalty and not a withhold arrangement.

(b) *Basic requirements.* (1) If used in the payment arrangement between the State and the MCO, PIHP, or PAHP, all applicable risk-sharing mechanisms, such as reinsurance, risk corridors, or stop-loss limits, must be described in the contract, and must be developed in accordance with §438.4, the rate development standards in §438.5, and generally accepted actuarial principles and practices.

(2) Contracts with incentive arrangements may not provide for payment in excess of 105 percent of the approved capitation payments attributable to the enrollees or services covered by the incentive arrangement, since such total payments will not be considered to be actuarially sound. For all incentive arrangements, the contract must provide that the arrangement is—

(i) For a fixed period of time and performance is measured during the rating period under the contract in which the incentive arrangement is applied.

(ii) Not to be renewed automatically.

(iii) Made available to both public and private contractors under the same terms of performance.

(iv) Does not condition MCO, PIHP, or PAHP participation in the incentive arrangement on the MCO, PIHP, or PAHP entering into or adhering to intergovernmental transfer agreements.

(v) Necessary for the specified activities, targets, performance measures, or quality-based outcomes that support program initiatives as specified in the State's quality strategy at §438.340.

(3) Contracts that provide for a withhold arrangement must ensure that the capitation payment minus any portion of the withhold that is not reasonably achievable is actuarially sound as determined by an actuary. The total amount of the withhold, achievable or not, must be reasonable and take into consideration the MCO's, PIHP's or PAHP's financial operating needs accounting for the size and characteristics of the populations covered under the contract, as well as the MCO's, PIHP's or PAHP's capital reserves as measured by the risk-based capital level, months of claims reserve, or other appropriate measure of reserves. The data, assumptions, and methodologies used to determine the portion of the withhold that is reasonably achievable must be submitted as part of the documentation required under §438.7(b)(6). For all withhold arrangements, the contract must provide that the arrangement is—

(i) For a fixed period of time and performance is measured during the rating period under the contract in which the withhold arrangement is applied.

(ii) Not to be renewed automatically.

(iii) Made available to both public and private contractors under the same terms of performance.

(iv) Does not condition MCO, PIHP, or PAHP participation in the withhold arrangement on the MCO, PIHP, or PAHP entering into or adhering to intergovernmental transfer agreements.

(v) Necessary for the specified activities, targets, performance measures, or quality-based outcomes that support program initiatives as specified in the State's quality strategy under §438.340.

(c) *Delivery system and provider payment initiatives under MCO, PIHP, or PAHP contracts*—(1) *General rule.* Except as specified in this paragraph (c), in paragraph (d) of this section, in a specific provision of Title XIX, or in another regulation implementing a Title XIX provision related to payments to providers, that is applicable to managed care programs, the State may not direct the MCO's, PIHP's or PAHP's expenditures under the contract.

(i) The State may require the MCO, PIHP or PAHP to implement value-based purchasing models for provider reimbursement, such as pay for performance arrangements, bundled payments, or other service payment models intended to recognize value or outcomes over volume of services.

(ii) The State may require MCOs, PIHPs, or PAHPs to participate in a multi-payer or Medicaid-specific delivery system reform or performance improvement initiative.

(iii) The State may require the MCO, PIHP or PAHP to:

(A) Adopt a minimum fee schedule for network providers that provide a particular service under the contract; or

(B) Provide a uniform dollar or percentage increase for network providers that provide a particular service under the contract.

(C) Adopt a maximum fee schedule for network providers that provide a particular service under the contract, so long as the MCO, PIHP, or PAHP retains the ability to reasonably manage risk and has discretion in accomplishing the goals of the contract.

(2) *Process for approval.* (i) All contract arrangements that direct the MCO's, PIHP's or PAHP's expenditures under paragraphs (c)(1)(i) through (iii) of this section must be developed in accordance with § 438.4, the standards specified in § 438.5, generally accepted principles and practices, and have written approval prior to implementation. To obtain written approval, a state must demonstrate, in writing, that the arrangement—

(A) Is based on the utilization and delivery of services;

(B) Directs expenditures equally, and using the same terms of performance, for a class of providers providing the service under the contract;

(C) Expects to advance at least one of the goals and objectives in the quality strategy in § 438.340;

(D) Has an evaluation plan that measures the degree to which the arrangement advances at least one of the goals and objectives in the quality strategy in § 438.340;

(E) Does not condition network provider participation in contract arrangements under paragraphs (c)(1)(i) through (iii) of this section on the network provider entering into or adhering to intergovernmental transfer agreements; and

(F) May not be renewed automatically.

(ii) Any contract arrangements that direct the MCO's, PIHP's or PAHP's expenditures under paragraphs (c)(1)(i) or (c)(1)(ii) of this section must also demonstrate, in writing, that the arrangement—

(A) Must make participation in the value-based purchasing initiative, delivery system reform or performance improvement initiative available, using the same terms of performance, to a class of providers providing services under the contract related to the reform or improvement initiative;

(B) Must use a common set of performance measures across all of the payers and providers;

(C) May not set the amount or frequency of the expenditures; and

(D) Does not allow the State to recoup any unspent funds allocated for these arrangements from the MCO, PIHP, or PAHP.

(d) *Pass-through payments under MCO, PIHP, and PAHP contracts.* (1) States may require MCOs, PIHPs, and PAHPs to make pass-through payments (as defined in paragraph (a) of this section) to network providers that are hospitals, physicians, and nursing facilities under the contract subject to the requirements of this paragraph (d). States may not require MCOs, PIHPs, and PAHPs to make pass-through payments other than those permitted under this paragraph.

(2) *Calculation of the base amount.* The base amount of pass-through payments is the sum of the results of paragraphs (d)(2)(i) and (ii) of this section.

(i) For inpatient and outpatient hospital services that will be provided to eligible populations through the MCO, PIHP, or PAHP contracts for the rating period that includes pass-through payments and that were provided to the eligible populations under MCO, PIHP, or PAHP contracts two years prior to the rating period, the State must determine reasonable estimates of the aggregate difference between:

(A) The amount Medicare FFS would have paid for those inpatient and outpatient hospital services utilized by the eligible populations under the MCO, PIHP, or PAHP contracts for the 12-month period immediately two years prior to the rating period that will include pass-through payments; and

(B) The amount the MCOs, PIHPs, or PAHPs paid (not including pass through payments) for those inpatient and outpatient hospital services utilized by the eligible populations under MCO, PIHP, or PAHP contracts for the 12-month period immediately 2 years prior to the rating period that will include pass-through payments.

(ii) For inpatient and outpatient hospital services that will be provided to eligible populations through the MCO, PIHP, or PAHP contracts for the rating period that includes pass-through payments and that were provided to the eligible populations under Medicaid FFS for the 12-month period immediately 2 years prior to the rating period, the State must determine reasonable estimates of the aggregate difference between:

(A) The amount Medicare FFS would have paid for those inpatient and outpatient hospital services utilized by the eligible populations under Medicaid FFS for the 12-month period immediately 2 years prior to the rating period that will include pass-through payments; and

(B) The amount the State paid under Medicaid FFS (not including pass through payments) for those inpatient and outpatient hospital services utilized by the eligible populations for the 12-month period immediately 2 years prior to the rating period that will include pass-through payments.

(iii) The base amount must be calculated on an annual basis and is recalculated annually.

(iv) States may calculate reasonable estimates of the aggregate differences in paragraphs (d)(2)(i) and (ii) of this section in accordance with the upper payment limit requirements in 42 CFR part 447.

(3) *Schedule for the reduction of the base amount of pass-through payments for hospitals under the MCO, PIHP, or PAHP contract.* Pass-through payments for hospitals may be required under the contract but must be phased out no longer than on the 10-year schedule, beginning with contracts that start on or after July 1, 2017. Pass-through payments may not exceed a percentage of the base amount, beginning with 100 percent for contracts starting on or after July 1, 2017, and decreasing by 10 percentage points each successive year. For contracts beginning on or after July 1, 2027, the State cannot require pass-through payments for hospitals under a MCO, PIHP, or PAHP contract.

(4) *Documentation of the base amount for pass-through payments to hospitals.* All contract arrangements that direct pass-through payments under the MCO's, PIHP's or PAHP's contract for hospitals must document the calculation of the base amount in the rate certification required in § 438.7. The documentation must include the following:

(i) The data, methodologies, and assumptions used to calculate the base amount;

(ii) The aggregate amounts calculated for paragraphs (d)(2)(i)(A), (d)(2)(i)(B), (d)(2)(ii)(A), (d)(2)(ii)(B) of this section; and

(iii) The calculation of the applicable percentage of the base amount available for pass-through payments under the schedule in paragraph (d)(3) of this section.

(5) *Pass-through payments to physicians or nursing facilities.* For contracts starting on or after July 1, 2017 through contracts beginning on or after July 1, 2021, the State may require pass-through payments to physicians and nursing facilities under the MCO, PIHP, or PAHP contract. For contracts beginning on or after July 1, 2022, the State cannot require pass-through payments for physicians or nursing facilities under a MCO, PIHP, or PAHP contract.

(e) *Payments to MCOs and PIHPs for enrollees that are a patient in an institution for mental disease.* The State may make a monthly capitation payment to an MCO or PIHP for an enrollee aged 21–64 receiving inpatient treatment in an Institution for Mental Diseases, as defined in § 435.1010 of this chapter, so

long as the facility is a hospital providing psychiatric or substance use disorder inpatient care or a sub-acute facility providing psychiatric or substance use disorder crisis residential services, and length of stay in the IMD is for a short term stay of no more than 15 days during the period of the monthly capitation payment. The provision of inpatient psychiatric or substance use disorder treatment in an IMD must meet the requirements for in lieu of services at §438.3(e)(2)(i) through (iii). For purposes of rate setting, the state may use the utilization of services provided to an enrollee under this section when developing the inpatient psychiatric or substance use disorder component of the capitation rate, but must price utilization at the cost of the same services through providers included under the State plan.

§ 438.7 Rate certification submission.

(a) *CMS review and approval of the rate certification.* States must submit to CMS for review and approval, all MCO, PIHP, and PAHP rate certifications concurrent with the review and approval process for contracts as specified in §438.3(a).

(b) *Documentation.* The rate certification must contain the following information:

(1) *Base data.* A description of the base data used in the rate setting process (including the base data requested by the actuary, the base data that was provided by the State, and an explanation of why any base data requested was not provided by the State) and of how the actuary determined which base data set was appropriate to use for the rating period.

(2) *Trend.* Each trend factor, including trend factors for changes in the utilization and price of services, applied to develop the capitation rates must be adequately described with enough detail so CMS or an actuary applying generally accepted actuarial principles and practices can understand and evaluate the following:

(i) The calculation of each trend used for the rating period and the reasonableness of the trend for the enrolled population.

(ii) Any meaningful difference in how a trend differs between the rate cells, service categories, or eligibility categories.

(3) *Non-benefit component of the rate.* The development of the non-benefit component of the rate must be adequately described with enough detail so CMS or an actuary applying generally accepted actuarial principles and practices can identify each type of non-benefit expense that is included in the rate and evaluate the reasonableness of the cost assumptions underlying each expense. The actuary may document the non-benefit costs according to the types of non-benefit costs under §438.5(e).

(4) *Adjustments.* All adjustments used to develop the capitation rates must be adequately described with enough detail so that CMS, or an actuary applying generally accepted actuarial principles and practices, can understand and evaluate all of the following:

(i) How each material adjustment was developed and the reasonableness of the material adjustment for the enrolled population.

(ii) The cost impact of each material adjustment and the aggregate cost impact of non-material adjustments.

(iii) Where in the rate setting process the adjustment was applied.

(iv) A list of all non-material adjustments used in the rate development process.

(5) *Risk adjustment.* (i) All prospective risk adjustment methodologies must be adequately described with enough detail so that CMS or an actuary applying generally accepted actuarial principles and practices can understand and evaluate the following:

(A) The data, and any adjustments to that data, to be used to calculate the adjustment.

(B) The model, and any adjustments to that model, to be used to calculate the adjustment.

(C) The method for calculating the relative risk factors and the reasonableness and appropriateness of the method in measuring the risk factors of the respective populations.

(D) The magnitude of the adjustment on the capitation rate per MCO, PIHP, or PAHP.

(E) An assessment of the predictive value of the methodology compared to prior rating periods.